

Board of Governors of the Federal Reserve System

**REPORT ON THE
AUDIT OF THE FEDERAL RESERVE'S
IMPLEMENTATION OF THE
COMMUNITY REINVESTMENT ACT**



OFFICE OF INSPECTOR GENERAL

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EXECUTIVE SUMMARY

Background

The Community Reinvestment Act (CRA) requires the federal financial supervisory agencies to use their examination and regulatory authority to assess an institution's record of meeting the credit needs of its entire community, including low- and moderate-income neighborhoods, consistent with safe and sound operations. The Division of Consumer and Community Affairs (C&CA) of the Board of Governors of the Federal Reserve System (the Board) carries out the Board's responsibilities under the CRA. C&CA formulates regulations, develops and administers supervision policies and procedures, oversees and coordinates the supervisory work of the Reserve Banks, and participates in Federal Financial Institutions Examination Council (FFIEC) activities to promote consistency among the federal financial supervisory agencies. The Reserve Banks' supervision personnel conduct CRA examinations under delegated authority from the Board as part of a broader consumer compliance examination program.

At the request of the President, the supervisory agencies revised their CRA regulations in 1995 to make CRA examinations more reflective of actual performance, to achieve greater consistency in CRA evaluations, and to lessen the burden associated with CRA regulations. The revised regulations became fully effective in July 1997.

Audit Purpose

We performed our audit to determine whether the Board's supervisory processes were achieving the goals of its revised regulation and to identify opportunities to help improve the implementation of the revised CRA evaluation process. We evaluated the policies and procedures used to conduct and report CRA examinations and reviewed the adequacy of interagency coordination efforts to achieve consistency in CRA evaluations.

Results

Overall, we found that the Board's supervisory processes associated with the revised CRA regulation have resulted in examinations that emphasize an institution's performance in the areas of lending, investments, and services without imposing unnecessary regulatory burden. Industry representatives and community groups whom we contacted generally concurred that the revised regulation has resulted in more performance-oriented CRA evaluations. The Board and the other supervisory agencies have devoted considerable time and energy to interagency coordination efforts, such as uniform examination procedures and guidance in the form of interpretive letters and questions and answers, that have fostered more consistent application of the regulations among the agencies. Furthermore, the agencies began assessing the implementation of the revised CRA evaluation criteria for small institutions through an interagency workgroup formed in 1996. In December 1997, the supervisory agencies also embarked on a joint project to improve CRA evaluations of large institutions by conducting joint examinations and reviewing a sample of CRA performance evaluation reports.

While good progress has been made, we identified additional opportunities for improvement. After completing our fieldwork on this audit, we met with C&CA senior management to review our preliminary findings and to get an update on activities related to improving the CRA examination process. We were told that Federal Reserve and interagency efforts had also identified many of the issues contained in our recommendations. Accordingly, C&CA management commented that, in certain cases, our recommendations would be fulfilled by initiatives that were either planned or already underway. Our recommendations, which are discussed in the body of the report, are designed to enhance the consistency of CRA evaluations and to improve the efficiency and effectiveness of CRA supervisory processes. Specifically, we recommend that

- the Board (a) issue additional guidance outlining the information that examiners should consider when developing the performance context and (b) require Reserve Banks to identify and maintain sources of this information;
- the Deputy Director of C&CA work with the FFIEC Task Force on Consumer Compliance to develop standard methodologies for assessing the CRA performance criteria;
- the Deputy Director of C&CA work with the FFIEC Task Force on Consumer Compliance to develop minimum content requirements and standard data presentation tables for CRA performance evaluation reports;
- the Deputy Director of C&CA work with the FFIEC Task Force on Consumer Compliance to review the regulatory definition of community development and to determine whether it unduly restricts loans, investments, and services from qualifying for CRA credit;
- the Director of C&CA improve the availability and reliability of data used in CRA examinations by (a) enhancing the quality of reported CRA data and (b) including more current demographic information and small business data;
- the Director of C&CA issue guidance on the level of CRA data verification required for large-bank examinations and specific error rates that would require banks to resubmit their CRA data;
- the Director of C&CA adopt guidelines for acceptable variances in the geocoding of CRA reported loans; and
- the Deputy Director of C&CA work with the FFIEC Task Force on Consumer Compliance to clarify CRA performance ratings of large institutions for the lending, investment, and service tests.

Analysis of Comments

We provided a draft of this report to the Director of C&CA for her review and comment. Her response, included as appendix 1, indicates general agreement with all but one of our recommendations. While she agrees with our recommendations to revisit the definition of community development and to clarify CRA ratings for performance criteria of large institutions (recommendations 4 and 8), she indicates that action may not be taken until the next overall review of the regulation, which is scheduled for 2002. While we understand that waiting until the scheduled review of the regulation may meet the convenience of C&CA staff and the FFIEC Task Force on Consumer Compliance, we believe the issues are of sufficient importance, as evidenced by financial services industry comments and Congressional interest, to warrant attention before 2002.

The director disagrees with our first recommendation to issue additional guidance to examiners on how to develop and apply the performance context, and require Reserve Banks to identify and maintain centralized sources of performance context information. Based on the wide variety of performance context presentations included in the CRA reports that we reviewed, and comments received from banks and community groups, we continue to believe that a minimum set of basic information requirements and clarification on how performance context data should be used when assessing CRA performance would enhance the CRA supervisory process and more effectively communicate agency expectations to banks and community groups. We also believe that maintaining a central source of information on community credit needs, availability of financial services, and local economic and demographic information for metropolitan areas and communities within each district, assembled from CRA examinations of multiple institutions and agencies along with other community contacts, would provide a more efficient, effective, and consistent means of developing the performance context.

BACKGROUND

The Community Reinvestment Act (CRA) requires the federal financial supervisory agencies to use their examination and regulatory authority to assess an institution's record of meeting the credit needs of its entire community, including low- and moderate-income neighborhoods, consistent with safe and sound operations.¹ The Division of Consumer and Community Affairs (C&CA) of the Board of Governors of the Federal Reserve System (the Board) carries out the Board's responsibilities under the CRA. C&CA formulates regulations, develops and administers supervision policies and procedures, oversees and coordinates the supervisory work of the Reserve Banks, and participates in Federal Financial Institutions Examination Council (FFIEC) activities to promote consistency among the federal financial supervisory agencies. The Reserve Banks' supervision personnel conduct CRA examinations under delegated authority from the Board as part of a broader consumer compliance examination program. The Board and Reserve Banks commit significant resources to conducting CRA examinations and collecting and maintaining CRA data. The Federal Reserve's estimated direct costs associated with the CRA supervision process for 1997 were about \$12 million, and about 63,000 examiner hours were spent on CRA examinations in 1997.

Legislative Requirements

The CRA was passed in 1977 amid concerns that financial institutions were taking deposits from depressed areas and lending funds elsewhere, thus accelerating economic decay of poorer neighborhoods and inhibiting their revitalization. The CRA requires the supervisory agencies to assess a financial institution's record of meeting the credit needs of its community and to take an institution's CRA record into account when evaluating an application for a deposit facility, which CRA defines as: a charter for a national bank or federal savings and loan association, a branch, deposit insurance, a merger, or an acquisition. The CRA also requires the supervisory agencies to prepare a written public evaluation report that includes (1) the agency's conclusions for each assessment factor identified in the implementing regulations, (2) a discussion of the facts supporting such conclusions, and (3) the financial institution's rating: outstanding, satisfactory, needs to improve, or substantial noncompliance. For financial institutions with interstate branches or branches in two or more states of a multistate metropolitan area, the supervisory agencies must present a separate written evaluation for each state or multistate metropolitan area, as well as an overall evaluation of the institution. Furthermore, the state-level evaluation must include a separate analysis for each metropolitan area in which the institution maintains one or more branches and separately for the remainder of the nonmetropolitan areas of the state if the institution maintains one or more branches in such nonmetropolitan area.

Regulatory History

¹ The federal financial supervisory agencies are the Office of the Comptroller of the Currency with respect to national banks; the Board with respect to state chartered banks that are members of the Federal Reserve System; the Federal Deposit Insurance Corporation with respect to state chartered banks that are not members of the Federal Reserve System; and the Office of Thrift Supervision in the case of a savings association or savings and loan holding company.

The federal financial supervisory agencies held hearings in 1978 to elicit the public's suggestions on how the CRA should be implemented. Because of the concern over the potential for the CRA to lead to credit allocation, the agencies adopted regulations that allowed financial institutions wide latitude in the ways that they ascertained and met credit needs in their communities. Under the 1978 regulations, the supervisory agencies examined institutions for their technical compliance with a few specific rules and qualitatively evaluated their record in serving their entire community. In assessing an institution's record of performance under the old regulations, the agencies considered the following twelve factors:

- Activities conducted to ascertain the credit needs of its community.
- The extent of the institution's marketing programs to make the community aware of the credit services offered by the institution.
- The extent of participation by the institution's Board of Directors in formulating policies and reviewing performance with respect to the CRA.
- Any practices intended to discourage applications for types of credit set forth in the institution's CRA statement.
- The institution's participation in government-insured, -guaranteed, or -subsidized loan programs for housing, small businesses or small farms.
- Evidence of prohibited discriminatory credit practices or other illegal credit practices.
- The institution's record of opening and closing offices and providing services at offices.
- The institution's participation, including investment, in local community development and redevelopment projects or programs.
- The institution's origination or purchase of residential mortgage loans, small business loans, and small farm loans in its community.
- The geographic distribution of the institution's credit extensions, credit applications, and credit denials.
- The institution's ability to meet various credit needs based on its financial condition and size, legal impediments, and local economic conditions.
- Other facts that reasonably bear upon the extent that an institution is helping meet the credit needs of its entire community.

Under the 1978 regulations, institutions believed that it was important to document their actions to identify and meet credit needs in order to substantiate their CRA efforts to examiners. This emphasis on documentation led many institutions to complain that the CRA examination process encouraged them to generate excessive paperwork on the processes they used to identify community credit needs and develop marketing programs. They argued that overemphasis on process and documentation hampered their lending. Financial institutions also criticized the supervisory agencies for not providing clear guidance on the CRA regulations and claimed that examination standards were applied inconsistently. Community groups and others agreed with the banking industry that there were inconsistencies in CRA evaluations. These inconsistencies led to uncertainty on the part of financial institutions about actions they needed to take in order to receive satisfactory CRA ratings. For community groups, inconsistencies were seen as a failure by the supervisory agencies to hold institutions accountable for meeting the needs of their community.

Noting these concerns, President Clinton requested in July 1993 that the supervisory agencies reform their CRA regulations. Specifically, the President asked the agencies to refocus the CRA examination system on more objective, performance-based standards that minimize compliance burden while stimulating improved performance. Among other things, the President asked that the agencies promote consistency and evenhandedness and improve CRA performance evaluations by focusing CRA examinations on results rather than on process and paperwork.

After receiving and analyzing public comments on regulatory proposals in 1993 and 1994, the supervisory agencies jointly adopted amended regulations in April 1995. In these new regulations, the supervisory agencies sought to make CRA examinations more reflective of actual performance, to achieve greater consistency in CRA evaluations, and to lessen the burden associated with CRA regulations. New data collection and reporting requirements and revised CRA examination procedures were developed and became fully effective in July 1997.

The revised regulations provide for CRA evaluations based primarily on an institution's record of performance for lending, investments, and services in its stated assessment area(s). An institution is subject to different rules and CRA evaluation criteria based on its characteristics. Generally, large institutions are subject to CRA evaluation based on their performance on lending, investment, and service tests, while small institutions are subject to more streamlined evaluation procedures based primarily on their lending performance.² In addition, large institutions are required to collect and report lending data to accommodate the examination process, while small banks are exempt from such reporting requirements. Wholesale or limited purpose institutions, which are not in the business of making loans to retail customers, are evaluated based on their community development activities. At an institution's request and upon approval by the appropriate supervisory agency, a financial institution may be evaluated on the basis of a strategic plan. The CRA performance evaluation criteria under the revised regulations are shown below in table 1.

² A small institution is defined as one that, as of December 31 of either of the prior two years, had total assets of less than \$250 million and was independent or an affiliate of a holding company that had total banking and thrift assets of less than \$1 billion. All others are considered large institutions under the CRA.

Table 1 – CRA Performance Evaluation Criteria

Type of Evaluation	Type of Test
Large bank	<p>Lending test</p> <ul style="list-style-type: none"> • Number and amount of loans in assessment area • Geographic distribution of loans, including proportion within an institution's assessment area and dispersion among geographies of different income levels • Distribution of loans based on borrower characteristics • Community development loans • Innovative or flexible lending practices <p>Investment test</p> <ul style="list-style-type: none"> • Dollar amount of qualified investments • Innovativeness and complexity of qualified investments • Responsiveness to community development needs • Degree to which investments are not provided by private investors • Benefits to assessment area <p>Service test</p> <ul style="list-style-type: none"> • Distribution of branches and record of opening and closing branches • Alternative systems for delivering bank services to low- and moderate-income people and geographies • Range of services provided • Extent of community development services provided • Innovativeness and responsiveness of community development services
Small bank	<p>Lending test</p> <ul style="list-style-type: none"> • Loan-to-deposit ratio • Percentage of loans in the institution's assessment area • Geographic distribution of loans • Distribution of loans based on borrower characteristics • Action taken in response to CRA complaints
Wholesale or limited purpose	<p>Community development test</p> <ul style="list-style-type: none"> • Number and amount of community development loans, qualified investments, or community development services • Use of innovative or complex investments, community development loans and services
Strategic plan	<ul style="list-style-type: none"> • Responsive to credit and community development needs • Achievement of strategic plan goals

CRA Examination Process

In November 1995, the supervisory agencies adopted uniform examination procedures to implement the revised CRA regulations. The CRA examination procedures are included in the Board's *Consumer Compliance Handbook*, which is designed to promote consistency among the Reserve Banks and to provide examiners with guidelines for conducting consumer compliance examinations, including CRA. As part of a CRA examination, examiners appraise a financial institution's stated assessment area(s) and select the assessment area(s) to be included in the on-site review. Examiners also identify the types of loans to be evaluated during the examination by considering the financial institution's business strategy and lending activity. Reserve Bank examiners have an automation tool, CRA Analyzer, available to assist in the analysis of lending,

demographic, and economic data for a financial institution and its assessment area(s) during a CRA examination.

Under the revised regulations, examiners evaluate an institution's performance on the lending, investment, and service tests in the context of information about the institution, its community, its competitors, and its peers. This performance context describes types of information about an institution and its community that an examiner must establish in order to assess the institution's performance. This information typically includes demographic and economic data about the institution's assessment area(s); the credit needs of its community; the institution's major business products and strategies; and its financial condition, capacity, and ability to lend or invest in its community. Consideration of these factors during a CRA examination reflects a fundamental underpinning of the new CRA regulations - that the differences in institutions and the communities in which they do business preclude rigid standards or quota-like benchmarks.

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of our audit was to determine whether the Board's supervisory processes were achieving the goals of the revised regulation, which were to (1) implement CRA examinations that emphasize performance rather than process, (2) promote consistency in CRA evaluations, and (3) eliminate unnecessary regulatory burden.

To accomplish our objective, we studied the legislative and regulatory history of the CRA and reviewed the Board's supervision policies, procedures, and guidance for conducting CRA examinations under both the old and new regulations. We reviewed the results of an interagency work group that was formed to identify and raise issues relating to CRA examinations of small institutions, and we attended an interagency forum addressing issues related to evaluations of large institutions. We visited six Reserve Banks and reviewed a judgmental sample of thirty-nine sets of workpapers and reports (fifteen large bank and twenty-four small bank) for CRA examinations that were completed during the period July 1997 through July 1998. We also reviewed seventeen public CRA evaluation reports from other supervisory agencies. CRA examinations of wholesale or limited purpose institutions and those evaluated under a strategic plan were excluded from the scope of our review because of the limited number of institutions evaluated under these procedures.

At each Reserve Bank that we visited, we spoke with examination management and staff and with representatives from community groups and banks to get their views on changes to CRA supervisory processes. We received feedback from a total of twelve community groups and twelve banks of varying asset size, geographic location, and CRA rating. We also met with individuals from C&CA and the other supervisory agencies to discuss issues relating to the revised CRA regulations and supervisory processes. We conducted our audit in accordance with generally accepted government auditing standards during the period September through November 1998.

FINDINGS AND RECOMMENDATIONS

Overall, we found that the Board's supervisory processes associated with the revised CRA regulation have resulted in examinations that emphasize an institution's performance for lending, investments, and services without imposing unnecessary regulatory burden. Industry representatives and community groups whom we contacted generally concurred that the revised regulations have resulted in more performance-oriented CRA evaluations. The Board and the other supervisory agencies have devoted considerable time and energy to interagency coordination efforts, such as uniform examination procedures and guidance in the form of interpretive letters and questions and answers, that have fostered more consistent application of the regulations among the supervisory agencies. Furthermore, the agencies began assessing the implementation of the revised CRA evaluation criteria for small institutions through an interagency workgroup formed in 1996. In December 1997, the supervisory agencies also embarked on a joint project to improve CRA evaluations of large institutions by conducting joint examinations and reviewing a sample of CRA performance evaluation reports. This project culminated in an interagency CRA forum held in October 1998 at which examination personnel from the supervisory agencies shared the results of their efforts and raised issues for further consideration by the FFIEC Task Force on Consumer Compliance.

While good progress has been made, we identified additional opportunities for improvement. Below we offer three recommendations to enhance the consistency of CRA evaluations and five recommendations to improve the efficiency and effectiveness of CRA supervisory processes.

After completing our fieldwork on this audit, we met with C&CA senior management to review our preliminary findings and to get an update on activities related to improving the CRA examination process. We were told that Federal Reserve and interagency efforts had also identified many of the issues contained in our recommendations. Accordingly, C&CA management commented that, in certain cases, our recommendations would be fulfilled by initiatives that were either planned or are already underway.

- 1. We recommend that the Board (a) issue additional guidance outlining the information that examiners should consider when developing the performance context and (b) require Reserve Banks to identify and maintain sources of this information.**

As mentioned above, an institution's performance under the tests and standards in the revised regulation is judged in the context of information about the institution, its community, its competitors, and its peers. This performance context analysis is an important factor in the revised CRA regulation, which reflects the fact that differences in institutions and the communities they serve preclude rigid standards or quota-like benchmarks.

While use of the performance context allows an examiner to exercise judgment in evaluating an institution's CRA performance, the inherent flexibility of the performance context can also be a source of inconsistencies in CRA evaluations. Our review of CRA performance evaluation (PE) reports disclosed wide variations in the content and thoroughness of performance context analyses in CRA evaluations. For example, some PE reports that we reviewed included a

detailed analysis of the economic and demographic characteristics of each census tract, while others showed this type of analysis at the metropolitan or assessment area level. Also, some examiners obtained information on economic conditions and business activity beyond that included in the CRA Analyzer software. In addition, several community groups whom we interviewed expressed their frustration that information provided to examiners regarding credit needs in their communities were either largely ignored or not appropriately reflected in the performance context of the PE report. Our review confirmed that information provided by community contacts was not always included in the examiner's written report. This variation in the level of detail and scope of information used to develop the performance context could lead to inconsistent application of the CRA performance criteria or complicate comparisons between institutions in the same assessment areas. Furthermore, Reserve Bank examination personnel whom we interviewed stated that there was no central source of information gathered from prior community contacts nor a repository of examiners' analyses from all supervisory agencies for communities and metropolitan areas in their region. Therefore, the performance context must be largely re-created for every examination.

While current examination procedures include the basic data that examiners should consider, we believe that the consistency of CRA evaluations could be enhanced by providing examiners with more specific guidance regarding the information to be used in developing the performance context. We also believe that the efficiency and effectiveness of the CRA examination process could be improved if the Reserve Banks maintained a historical knowledge base of this performance context information for use by examiners on other CRA examinations.

2. We recommend that the Deputy Director of C&CA work with the FFIEC Task Force on Consumer Compliance to develop standard methodologies for assessing the CRA performance criteria.

The revised regulations establish specific performance criteria that examiners use to evaluate institutions' CRA activities. As shown previously, the performance criteria establish the specific aspects of an institution's lending, investment, and service activities that are reviewed as part of the CRA examination process. While the performance criteria in the new regulations provide uniformity by specifying the activities assessed during a CRA examination, there is no guidance that stipulates the methodologies that examiners should use to assess an institution's performance in these areas.

Our reviews of PE reports and examination workpapers revealed considerable variation in the methods examiners used to assess performance criteria. For example, some examiners assessed "geographic distribution" under the lending test by first establishing the distribution of business loans among census tracts of different income categories. An evaluation of the geographic distribution was then made by comparing this result to the distribution of the number of businesses in these census tracts. In contrast, other examiners used a totally different approach and judged this performance criterion by comparing the distribution of business loans among census tracts of different income levels to the distribution of residential population in the census tracts.

Under the investment test, we noted differences in how examiners evaluated institutions' "responsiveness to community development needs." Some examiners calculated the percentage of the total investment portfolio comprising an institution's community development investments as a measure of responsiveness, while others made no calculation, but used qualitative criteria derived from information developed in the performance context.

The "distribution of branches" performance criterion under the service test provides an additional example of the varying approaches. We found that the analysis performed ranged from very brief to extremely detailed. Some examiners offered only a few terse statements affirming that the institution's delivery systems are accessible to low- and moderate-income areas. In contrast, other examiners performed a detailed branch distribution analysis using the percentage of families residing in census tracts for different income categories.

While these examples are not a complete list of the variations that we found during our audit, we believe that they illustrate that a more standard approach to assessing performance criteria would enhance the consistency of the CRA evaluation process. Examiners attending an interagency CRA forum supported this point and recommended that the supervisory agencies adopt standard methodologies to guide analysis of performance criteria in the lending, investment, and service tests. We recognize that not all of the performance criteria are amenable to a standard methodology; nevertheless, we believe that adopting consistent methodologies, where practical, would lead to greater consistency in CRA evaluations and would facilitate more meaningful comparisons among institutions.

3. We recommend that the Deputy Director of C&CA work with the FFIEC Task Force on Consumer Compliance to develop minimum content requirements and standard data presentation tables for CRA performance evaluation reports.

The CRA requires the agencies to prepare a written evaluation of a financial institution's record of meeting the credit needs of its community upon completion of each examination. Under the statute, the public section of the PE report must include the supervisory agency's conclusions for each assessment factor identified in the regulations, a discussion of the facts supporting such conclusions, the institution's rating, and a statement describing the basis for the rating. Neither the CRA nor the implementing regulations specify the nature or extent of data that should be included in the PE report.

Our review of PE reports from Reserve Banks and other agencies showed a wide variety of report formats and content of data presented to support examiner conclusions. Most of the variation in the PE reports was related to the kinds of data presented and the number of tables used to support examiner conclusions regarding the performance context and the financial institution's record on the lending test. Examiners at an interagency CRA forum also concluded that the agencies should develop a consistent report format and standard data presentation tables. Many community groups whom we interviewed indicated that the variation in PE reports makes it difficult to compare CRA performance among institutions.

We believe that uniform interagency standards for the format and content of PE reports would enhance the consistency of the CRA supervision process and simplify comparisons across

institutions and agencies. The efficiency of PE report preparation may also improve once examiners become accustomed to a more standard format.

4. We recommend that the Deputy Director of C&CA work with the FFIEC Task Force on Consumer Compliance to review the regulatory definition of community development and to determine whether it unduly restricts loans, investments, and services from qualifying for CRA credit.

In each of the performance tests applied during a CRA evaluation, examiners use the regulatory definitions of community development to determine whether specific loans, investments, or services qualify for CRA credit. To perform their analysis, examiners use the definitions in the regulation along with subsequent guidance from interagency interpretive letters and questions and answers (Q&A). In defining the term *community development*, the agencies attempted to limit CRA credit to activities that primarily benefit low- and moderate-income individuals or geographies. Under the regulation, community development activities are defined as

- affordable housing (including multifamily rental housing) for low- or moderate-income individuals,
- community services targeted to low- or moderate-income individuals,
- activities that promote economic development by financing businesses or farms that meet the size eligibility standards of the Small Business Administration's Development Company or Small Business Investment Company programs or that have gross annual revenues of \$1 million or less, or
- activities that revitalize or stabilize low- or moderate-income geographies.

Many Reserve Bank examiners, bankers, and community groups whom we interviewed commented that the regulatory definition of community development is too restrictive. We believe that their concerns have merit. For example, in 1997, a Q&A addressed the definition of community development as it relates to activities that promote economic development by financing businesses or farms meeting certain size or eligibility standards. The specific issue addressed by the Q&A was whether activities that finance certain small businesses and farms (not otherwise reported as small-business or farm loans) automatically qualify under the community development definition. The response in the Q&A stated that to qualify as community development, a loan, investment, or service must meet both a size and purpose test. Examiners at an interagency CRA forum and several bankers that we interviewed noted that the restrictive nature of this test has precluded some economic development activities from qualifying for CRA credit as community development loans, investments, and services.

According to participants at an interagency CRA forum, many worthy activities do not qualify for CRA credit because of the difficulty in proving that community development, as defined in

the regulations, is the primary purpose. To meet the primary purpose test, institutions are required to document income data that shows that persons being served by a particular activity are primarily low- and moderate-income individuals. We found that this requirement is widely viewed as overly burdensome, and bankers that we interviewed considered the requirement of documenting beneficiaries' income levels inconsistent with the goals of the revised regulations. This concern was also raised in discussions about the regulatory definition of *affordable housing*. Participants in the interagency CRA forum commented that it is often difficult to find sufficient data to prove that affordable housing is for the primary benefit of low- and moderate-income individuals. Nevertheless, according to regulatory interpretation, it is the income of residents that determines whether a project qualifies as affordable housing.

We understand that the definition of community development has been the subject of discussion among the regulatory agencies for some time and that this is not a new issue. However, given the view of examiners, bankers, and community groups that the current regulatory definition of what qualifies for CRA credit can keep worthy projects from receiving CRA credit and preclude banks from participating in certain community development activities, we believe that the community development definition needs to be revisited.

5. We recommend that the Director of C&CA improve the availability and reliability of data used in CRA examinations by (a) enhancing the quality of reported CRA data and (b) including more current demographic information and small business data.

Reserve Bank examiners use data from multiple sources when conducting CRA examinations. These sources include CRA and Home Mortgage Disclosure Act (HMDA) data reported annually by depository institutions, statistics from the U.S. Department of Housing and Urban Development, data from the Bureau of Labor and Statistics, and census data. Most of the data used during an examination have been incorporated into CRA Analyzer, while some information is left to the examiner to collect and assimilate. Examiners use these data to help develop the performance context and evaluate a financial institution's lending activity.

Reserve Bank examiners whom we interviewed raised concerns about the reliability and availability of certain data used in CRA evaluations. Examiners related several instances in which they encountered significant errors in CRA loan data reported by large institutions. In addition, there was widespread agreement among examiners that the 1990 census data were outdated. One Reserve Bank that we visited encouraged examiners to obtain updated demographic information from state and local governments. We also found inconsistent use of small-business data among Reserve Banks. Small-business data are not included with the CRA Analyzer software, but some Reserve Banks have obtained these data from industry sources and use the information for analysis of institutions' performance on the lending test.

We believe that several initiatives could be taken to provide more reliable data for the CRA examination process. In our view, C&CA should clarify large-bank reporting requirements under the CRA regulations to address the apparent misunderstanding of which loans qualify as CRA-reportable. In addition, C&CA should adopt guidelines requiring examiners to review a bank's CRA data collection and reporting processes when considerable errors are identified by

the examiner's verification procedure. Other supervisory agencies have instituted this procedure in recognition of the quality problem with reported CRA data. Examiners should also be encouraged to identify sources of more current demographic data to supplement outdated census data. C&CA should also provide small-business data to the Reserve Banks, along with guidance on how they should be used in CRA examinations.

6. We recommend that the Director of C&CA issue guidance on the level of CRA data verification required for large-bank examinations and specific error rates that would require banks to resubmit their CRA data.

CRA examination procedures require examiners to verify the accuracy of a large bank's reported CRA data, but there are no definitive sampling requirements for this verification procedure. During our Reserve Bank visits, we found considerable variations in the level of data verification being performed. Data verification levels ranged from verifying data only if time permitted to extensive sampling practices similar to those in place for HMDA data. Furthermore, there is no standard error rate that would require a bank to resubmit its CRA data. During our Reserve Bank visits, we found a variety of opinions among examiners concerning acceptable error rates in reported CRA data. The need for a standard error rate threshold was also raised by participants at an interagency CRA forum.

We believe that data verification standards should be established to ensure the validity of data used in CRA examinations. While the level of verification required for HMDA data may not be warranted for CRA data, similar guidance should be provided. The level of verification could be reduced based on a bank's previous record of data reporting and level of controls over the process of collecting and reporting the CRA data. Furthermore, to promote accuracy of CRA data, a standard error rate threshold should be established to determine when a bank must resubmit its data.

7. We recommend that the Director of C&CA adopt guidelines for acceptable variances in the geocoding of CRA reported loans.

As mentioned above, examiners typically verify a sample of a bank's reported CRA data during the large bank CRA examination. One of the specific data elements verified is the geographic classification of a bank's loans. Placing each loan into a census tract or block numbering area is known as *geocoding*. Geocoding provides the basis for determining the geographic distribution of a bank's lending activity in low-, moderate-, middle-, or upper-income census tracts.

There is a wide disparity of results among geocoding software products used by the supervisory agencies and financial institutions. Differences in these results are caused by timing variances of geographic database updates and software parameter settings for address matching. These differences occur among the various software tools used by the agencies, as well as third-party software used by some financial institutions. This disparity results in geocoding discrepancies that examiners must reconcile. Several Reserve Bank examiners and bankers that we

interviewed expressed frustration with the differences encountered among the various software tools and the time spent reconciling discrepancies during the examination process.

We realize that because various software products are used, discrepancies in geocoding among products are inevitable. However, we believe that C&CA could reduce the time spent reconciling these discrepancies by directing examiners to accept variances as long as the following three criteria are met:

- The geographic database originates from an industry-accepted vendor.
- The database is no more than one year old from the time that the geocoding occurred.
- The address-matching function is at a level acceptable to C&CA.

8. We recommend that the Deputy Director of C&CA work with the FFIEC Task Force on Consumer Compliance to clarify CRA performance ratings of large institutions for the lending, investment, and service tests.

The revised CRA regulations stipulate five rating categories for each of the large institution performance tests: *Outstanding*, *High Satisfactory*, *Low Satisfactory*, *Needs to Improve*, and *Substantial Noncompliance*. The *High Satisfactory* rating category was established to recognize the efforts of institutions whose CRA performance was above satisfactory, yet not at the level considered *Outstanding* under the revised regulations.

Application of the *High Satisfactory* and *Low Satisfactory* rating categories has caused consternation among some bankers and examiners. In instances where an institution's performance under the test being evaluated is considered satisfactory, the examiner must choose between either the *High* or *Low Satisfactory* designations. According to many bankers and examiners whom we interviewed, the *Low Satisfactory* rating clearly carries a negative connotation. Because the individual ratings for each performance test are included in the public CRA evaluation report, many institutions are disconcerted upon receiving a *Low Satisfactory* performance rating. We are concerned that this situation may lead to inflated ratings in cases where examiners want to avoid undue conflict with financial institutions over the implied meanings of performance ratings. Examiners attending the interagency forum on large bank CRA examinations indicated that they would prefer having a *Satisfactory* rating category to eliminate the negative perception of *Low Satisfactory*, and allow them to focus their time on analysis of CRA issues, rather than arguing semantics. We believe that the FFIEC Task Force on Consumer Compliance could facilitate implementation of the new CRA regulations by replacing the term *Low Satisfactory* with *Satisfactory* or by combining the *High* and *Low Satisfactory* ratings into a single *Satisfactory* rating.

ANALYSIS OF COMMENTS

We provided a draft copy of this report to the Director of C&CA for her review and comment. Her response, included as appendix 1, indicates general agreement with all but one of our recommendations. While she agrees with our recommendations to revisit the definition of community development and to clarify CRA ratings for performance criteria of large institutions (recommendations 4 and 8), she indicates that action may not be taken until the next overall review of the regulation, which is scheduled for 2002. While we understand that waiting until the scheduled review of the regulation may meet the convenience of C&CA staff and the FFIEC Task Force on Consumer Compliance, we believe the issues are of sufficient importance, as evidenced by financial services industry comments and Congressional interest, to warrant attention before 2002.

The director disagrees with our first recommendation to issue additional guidance to examiners on how to develop and apply the performance context, and require Reserve Banks to identify and maintain centralized sources of performance context information. Her response indicates that the agencies, in developing the revised regulation, believed that examiners should be encouraged to use their judgement in identifying the data elements to consider during each CRA examination and that attempting to provide more guidance in the interest of consistency could prove to be of little value, given the broad range of economic, social, and demographic circumstances that would need to be covered. She also stated that Reserve Banks maintain the sources of information used in developing the performance context, and make use of previously developed information when appropriate.


We agree that examiners should exercise their judgement when developing the performance context and assessing the CRA performance of institutions. But based on the wide variety of performance context presentations included in the CRA reports that we reviewed, and comments received from banks and community groups, we continue to believe that a minimum set of basic information requirements and clarification on how performance context data should be used when assessing CRA performance would enhance the CRA supervisory process and more effectively communicate agency expectations to banks and community groups. Furthermore, while we recognize that Reserve Banks retain CRA examination reports and workpapers for a period of time, they do not provide an efficient means of obtaining all information previously gathered on metropolitan areas or communities within Reserve Bank districts. We therefore believe that maintaining a central source of information on community credit needs, availability of financial services, and local economic and demographic information for metropolitan areas and communities within each district, assembled from CRA examinations of multiple institutions and agencies along with other community contacts, would provide a more efficient, effective, and consistent means of developing the performance context.

APPENDIXES

Appendix 1 – Division's Comments

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Office Correspondence

DATE: March 5, 1999
TO: Barry R. Snyder
FROM: Dolores S. Smith 
SUBJECT: Draft Report on the Audit of the Federal Reserve's Implementation of the Community Reinvestment Act

Thank you for the opportunity to comment on the draft *Report on the Audit of the Federal Reserve's Implementation of the Community Reinvestment Act*. We appreciate the OIG's recognition, as reflected in the draft report, that the Board's supervisory processes have resulted in CRA examinations that emphasize an institution's performance in the areas of lending, investments, and services without imposing unnecessary regulatory burden. The Division has expended considerable time and energy in interagency coordination efforts, and those efforts have resulted in more consistent application of the CRA regulation among the agencies. Indeed, through these interagency efforts, we have already begun to address many of the recommendations made in the report as noted in the following comments. And while we disagree with some of the report's recommendations, we also appreciate the OIG's efforts to make constructive suggestions for improvement in this area.

1. We recommend that the Board/Director of C&CA (a) issue additional guidance outlining the information that examiners should consider when developing the performance context and (b) require Reserve Banks to identify and maintain sources of this information.

Generally disagree.

- (a) The OIG notes that current examination procedures establish the basic data that examiners should consider when developing a performance context, but goes on to state that providing examiners with more specific guidance regarding the information to be used in developing the performance context could enhance the consistency of CRA evaluations. In support of this recommendation, the OIG points to "wide variations" in the content and thoroughness of performance context analyses in CRA evaluations, as evidenced by the inclusion of a detailed analysis of the economic and demographic characteristics of each census tract in some public evaluations, and the analysis in others at the metropolitan or assessment area level.

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In developing the revised CRA regulation, the agencies sought to recognize that differences exist among the communities across the nation. The agencies determined, after due consideration, that examiners should be encouraged to use their judgment in identifying, on a case-by-case basis, the data elements most relevant to each CRA examination. The interagency examination procedures instruct the examiner to discuss the institution's performance at the metropolitan/non-metropolitan area or, when appropriate, at the assessment area level. A discussion in the public evaluation at the census tract level could be appropriate if the characteristics of the tracts have an impact on how performance is evaluated. Attempting to provide more specific guidance regarding the information to be used in developing a performance context in the interest of consistency could prove to be of little value, and could even be counterproductive, because it would have to cover an extremely broad range of economic, social, and demographic circumstances. We believe the adequacy of documentation in the workpapers is a more meaningful measure of the thoroughness of the performance context analysis, given that the workpapers tend to include more information than the public evaluations. The Division's review of workpapers during our 1998 operations reviews indicated to us that examiners are adequately considering appropriate information when developing performance contexts.

- (b) Currently, Reserve Banks maintain the source of information used to develop a performance context and make use of previously developed information again when appropriate. We confirmed this practice with four Reserve Banks. Moreover, because the System supervises just fewer than 1,000 banks nationwide, it is rarely the case that precisely the same information can be used in examinations of different banks. Reserve Bank staff already share the sources and types of information they have found helpful in developing performance contexts. These discussions take place at the System's HMDA/CRA Users Group meetings, through experiences gained during the examiner pooling program, and other more informal means. These efforts have been underway for several years. More recently, the audience of the HMDA/CRA Users Group meetings (formerly the HMDA Users Group) was expanded to include CRA in September 1998, and CRA is being discussed at the March 1999 Senior Forum.

2. We recommend that the Deputy Director of C&CA work with the FFIEC Task Force on Consumer Compliance to develop standard methodologies for assessing the CRA performance criteria.

In process. The OIG states that "there is no guidance that stipulates the methodologies examiners should use to assess an institution's performance in these areas." In fact, however, the interagency CRA examination procedures guide examiners on the information they should review when evaluating a financial institution with respect to each of the performance criteria. Nevertheless, examiners may look at the information in different ways and may include different data items from a bank's performance context in the public evaluation, and this is an issue that was identified during the interagency public evaluation review carried out between December 1997 and March 1998. A recommendation to address the issue was made at the CRA Forum of October 1998, and the FFIEC Task Force on Consumer Compliance is considering whether the current examination procedures should be augmented in this respect.

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3. We recommend that the Deputy Director of C&CA work with the FFIEC Task Force on Consumer Compliance to develop minimum content requirements and standard data presentation tables for CRA performance evaluation reports.

In process. This issue was identified in the course of the interagency performance evaluation review, and the Task Force has been actively studying it for some time. The Task Force recently determined, however, that its work on standardized elements for the public evaluations should be deferred until the revisions currently in process for the interagency staff commentary are completed.

4. We recommend that the Deputy Director of C&CA work with the FFIEC Task Force on Consumer Compliance to review the regulatory definition of community development and to determine whether it unduly restricts loans, investments, and services from qualifying for CRA credit.

In process. The community development definition in the CRA regulation focuses on economic development and other activities that primarily benefit low- and moderate-income individuals and areas. The Task Force, which has had the definition of community development under advisement for some time, believes this focus is consistent with the CRA, which encourages banks and thrifts to help meet the credit needs of their entire communities, including low- and moderate-income neighborhoods. However, the Task Force recognizes that there has been some concern that it is difficult to show that activities primarily benefit low- and moderate-income individuals. As a result, the agencies have developed a new question for the Interagency Questions and Answers, which the agencies expect to adopt soon, explaining how to determine whether an activity or project has a primary purpose of community development. The agencies believe this revised interpretation, if adopted, will have the effect of expanding the number of projects that can be considered as having a primary purpose of community development. In addition, when the CRA regulation was revised in 1995, the agencies indicated that they would comprehensively review the regulation, including definitions, in 2002. This review will include further analysis of the definition of community development.

5. We recommend that the Director of C&CA improve the availability and reliability of data used in CRA examinations by (a) enhancing the quality of reported CRA data, and (b) including more current demographic information and small business data.

In process.

(a) The Division has periodically addressed the issue of data quality with the Reserve Banks since the regulation was implemented, most recently following the issuance of a supervisory letter by one of the other banking agencies. Our discussions with the Reserve Banks indicate that none has experienced significant problems with the quality of the reported CRA data. However, in light of the OIG's recommendation, the Division will

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convene a System workgroup to study the issue and determine what, if any, additional guidance is required.

- (b) Because the census data are collected only once every ten years, it is inevitable that the data will become outdated before the next release. It is sometimes helpful to obtain updated demographic data from local sources, which is currently done on a case-by-case basis. Not all localities and states update the demographic data for their respective areas on a continual basis. Therefore, it should be left to the examiners' judgment to determine whether updated data would be beneficial. In some cases, if updated data are unavailable for all of the localities in a bank's assessment area or for the localities of other similarly situated institutions, the use of data other than the most recent census data may not be appropriate. In addition, through the HMDA/CRA Users Group and other more informal means, the Reserve Banks share with each other the sources of updated demographic data. It should also be noted that the System's Tactician CRA Analyzer automated data analysis and mapping program uses the best data available on a nationwide basis, and more localized information may be of limited use to some Reserve Banks. Regarding small business data, the next update to the CRA Analyzer program, which is expected to be released in March 1999, will include the most recent Dun & Bradstreet small business data. The Division has been working with Tactician Corporation on incorporating the small business data into the program since the first quarter of 1998.

6. We recommend that the Director of C&CA issue guidance on the level of CRA data verification required for large bank examinations and specific error rates that would require banks to resubmit their CRA data.

Concur. The System's Examination Process Subcommittee will add this issue to its list of projects. Realistically, a solution to this issue will not be implemented until 2000.

7. We recommend that the Director of C&CA adopt guidelines for acceptable variances in geocoding of CRA reported loans.

In process. The OIG's draft report notes that there are differences in geocoding results among geocoding software products because of timing variances of geographic database updates and software parameter settings. The Richmond Federal Reserve Bank reported the geocoding differences to this Division and the issue was discussed at the 1998 HMDA/CRA Users Group meeting in Denver. As a result of that discussion, a System workgroup was put in place to review these differences and make a recommendation on how to proceed. A firm conclusion regarding the cause of the differences has not yet been reached. Much additional analysis is needed on this issue and the workgroup will continue its efforts to clarify the cause of the problem and make appropriate recommendations.

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8. We recommend that the Director of C&CA work with the FFIEC Task Force on Consumer Compliance to clarify CRA performance ratings of large institutions for the lending, investment, and service tests.

In process. This issue was discussed during the 1998 FFIEC CRA Forum. Since addressing this issue would require a regulatory change, the Task Force has determined that it is appropriate to review this issue during the next overall review of the regulation, which is currently scheduled for 2002.

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APPENDIX 2 – Principal OIG Contributors to this Report

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